Linda Frenklak
Tax Counsel III
Board of Equalization, Appeals Division
450 N Street, MIC: 85
PO Box 942879
Sacramento, CA 95814
Tel: (916) 323-3087
Fax: (916) 324-2618

Attorney for the Appeals Division

BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**HEARING SUMMARY**[2]
	PERSONAL INCOME TAX APPEAL
SEMYON SHEKHTER AND	Case No. 740750
ELENA SHEKHTER[1]	

Year	Claimed R&D Credit Amount	Refund Claimed[3]
2007	$47,829	$42,902

Representing the Parties:

For Appellants: Clark A. Samuelson, Jr., Alliantgroup

For Franchise Tax Board: D. Todd Watkins, Tax Counsel III

QUESTIONS: (1) Whether appellant-husband, the sole shareholder of Atlas Mechanical, Inc. (Atlas), a California subchapter S corporation, is entitled to claim a pass-through California research and development (R&D) credit in the absence of a claimed R&D

[1] Appellants reside in San Diego.

[2] This appeal was originally scheduled for the June 24, 2014 oral hearing calendar. The Board granted appellants' request for a postponement and rescheduled the appeal for the October 14, 2014 oral hearing calendar.

[3] The claimed refund amount consists of the $40,311 amount of tax appellants remitted with their original 2007 return plus the $2,591 amount of refund appellants claimed on their 2007 amended return. (Resp. Opening Br., exhibit D, p. 2, line 65; exhibit E, p. 8, line 66.)

credit by Atlas.

(2) If appellant-husband may claim a pass-through California R&D credit in the absence of a claimed R&D credit by Atlas, whether appellants have demonstrated that Atlas was entitled to the claimed R&D credit under Revenue & Taxation Code (R&TC) section 23609.

HEARING SUMMARY

Background

Appellant-husband is the sole shareholder of Atlas, a plumbing, heating, and air conditioning contractor in the construction industry located in San Diego, California. Atlas was incorporated in California in 1991. (Resp. Opening Br., pp. 1-2.)

On April 24, 2008, Atlas filed a California S corporation Franchise or Income Tax Return (Form FTB 100S) for 2007. Atlas's 2007 return includes a Schedule K-1, Shareholder's Share of Income, Deductions, Credits, etc., which lists appellant-husband as having 100 percent of Atlas's stock ownership at year end. Atlas's 2007 return also includes a Schedule R, which indicated that Atlas conducted business both in and out of California and apportioned all of Atlas's income to California. On its 2007 return, Atlas did not claim an R&D credit. Atlas never filed an amended return for tax year 2007. (Resp. Opening Br., pp. 1-2, exhibit A.)

On April 15, 2008, appellants filed a California Resident Income Tax Return (Form FTB 540) for 2007.[4] On their 2007 return, appellants did not claim an R&D credit. They self-assessed a tax liability of $352,770. After adding a mental health services tax of $28,404 and subtracting an other state tax credit of $9,267, income tax withholdings of $13,612, and 2007 estimated tax payments of $318,000, appellants reported a tax due of $40,295 plus an underpayment of estimated tax of $16, amounting to a total amount due of $40,311. They remitted a $40,311 payment by the April 15, 2008 due date. (Resp. Opening Br., pp. 1-3, exhibits B-D.)

[4] Respondent no longer has a copy of appellants' 2007 original return. Respondent obtained information regarding the 2007 account from its electronically-stored data. Appellants attached a copy of their 2007 original return to their 2007 amended return. (Resp. Opening Br., pp. 1-2, exhibits B-F.)

According to respondent, appellants timely filed an amended 2007 California individual tax return (Form 540X).[5] On their amended 2007 return, appellants reported a pass-through R&D credit of $47,829 based on an attached amended California Schedule K-1 from Atlas, and claimed a refund of $2,591. Appellants indicated on the amended return that they did not file an amended federal return with the Internal Revenue Service (IRS) on a similar basis. (Resp. Opening Br., pp. 1-3, exhibits B-F.)

Respondent audited appellants' 2007 amended return. In a letter to appellant-husband dated February 6, 2013, respondent indicated that, although appellants' 2007 claim for refund is based on their receipt of an amended Schedule K-1 from Atlas for 2007, Atlas did not file an amended 2007 return, and Atlas did not claim an R&D credit in 2007. Respondent asserted that it would thus be unable to allow appellants their claim for refund without documentation substantiating appellants' claim for refund. Respondent requested additional evidence that might support appellants' claim for refund. It appears that no further evidence was provided. Following additional correspondence, respondent denied the claim for refund in a letter to appellants dated March 22, 2013. (Appeal Letter, pp. 1-2, attachments.)

This timely appeal followed.

Contentions

Appellants' Contentions

Subchapter S Items

Appellants argue that they are entitled to claim their *pro rata* share of Atlas's R&D credit for 2007 pursuant to R&TC section 23803, subdivision (a)(2)(F), even though Atlas failed to file an amended S corporation return for 2007. Appellants state, "For the 2007 tax year, Atlas did not amend its return to show the research and development tax credit, because any filing would have been past the statute of limitations." Appellants contend that, with their 2007 amended return, they "included a pro-forma Schedule K-1 from Atlas, which showed a research and development tax credit." They also assert that Atlas is not required to file an amended return reporting the R&D credit "in order

[5] Respondent previously argued that appellants' refund claim was barred by the statute of limitations. However, during the appeal, in correspondence dated June 17, 2014, respondent conceded this issue.

to allow the flow-thru credits for its shareholders." Appellants assert that, because it is undisputed that appellant-husband is the sole shareholder of Atlas, there is no merit to respondent's contention "that without the S corporation return, it would have no way of knowing that a shareholder's *pro rata* share of the S corporation items have been distributed *pro rata* to the shareholder." Appellants also assert "that one would only need the original S corporation return and a calculator to determine if a taxpayer has in fact received his pro rata share[.]" Appellants further assert that the S corporation's return "is merely informational, and has no effect on an individual's tax return" due to the flow-through nature of an S corporation. Appellants state, "The S-Corporation's filing of the credit only serves the purpose of offsetting the tax on net income at the S-Corporation level." (Appeal Letter, pp. 1-3; App. Reply Br., pp. 2-4; App. Supp. Br., pp. 5-6.)

Appellants argue that *Bufferd v. Commissioner* (1993) 506 U.S. 523 is controlling. According to appellants, the United States Supreme Court held that the individual shareholder's return, rather than the S corporation's return, was the relevant return for determining the shareholder's tax liability. According to appellants, "the situation in *Bufferd* is analogous to [their] situation" because "the relevant return is the shareholder's individual tax return." (Appeal Letter, pp. 2-3; App. Reply Br., pp. 4-5; App. Supp. Br., p. 6.)

Lastly, appellants contend that their failure to report consistently between their 2007 amended return and Atlas's 2007 return is not fatal to their claim for refund. Appellants assert that the FTB's own brief states that a shareholder "'who does not notify the government of the inconsistently reported S corporation item . . . [is] generally ***limited*** to post-payment review after filing a claim for a refund.'" (App. Supp. Br., p. 7.)

R&D Credit

With respect to respondent's argument that appellants failed to substantiate that Atlas is entitled to the R&D credit, appellants contend, during the audit, respondent never raised this issue, requested documents to substantiate the claimed R&D credit, or claimed appellants were not entitled to the claimed R&D credit because they failed to substantiate Atlas is entitled to the R&D credit. Appellants assert that respondent only requested information concerning the issue of whether appellants timely filed their claim for refund. Appellants state, "Had Respondent actually audited Appellants'

research credit, Atlas would have provided substantial documentation to back up the claim, and is still willing to do so." Appellants contend that respondent neither audited Atlas's activities nor visited Atlas's facility "to get a firsthand view of the activities." (App. Reply Br., p. 5; App. Supp. Br., pp. 4-5.)

Appellants assert that respondent incorrectly contends appellants base their entitlement to the R&D credit "solely on the amended Schedule K-1 from Atlas." According to appellants, "Atlas engaged Alliantgroup to qualify and quantify the activities it performed that qualified the company for a research and development tax credit" and it reviewed a large amount of documents to verify the various activities and amounts, including financial statements, time tracking data, requests for information, drawings, notes, and design review comments. Appellants indicate that Alliantgroup held interviews with Atlas personnel "to discuss the various activities performed by Atlas and specific projects undertaken by Atlas during the year in question." Appellants assert that, upon the completion of "this thorough review," Atlas determined it was entitled to an R&D credit for a specific amount for 2007. Appellants request that the Board grant appellants' claim for refund or, alternatively, "allow Atlas the opportunity to show the FTB the documents and supporting information that proves it is entitled to a research and development tax credit." (App. Supp. Br., pp. 4, 7.)

Respondent's Contentions

Subchapter S Items

Respondent argues that appellants have failed to meet their burden of proving they are entitled to a pass-through R&D credit from Atlas for 2007. Respondent contends that the R&D credit claimed on appellants' 2007 amended return "could not have been based on receipt of an amended Schedule K-1" from Atlas because "the filing by Atlas of an amended Form 100S was a prerequisite for the issuance of an amended Schedule K-1." Respondent asserts that the S corporation includes with its filed return a Schedule K-1 reporting the shareholders' *pro rata* shares and it provides copies of the Schedule K-1 to its shareholders. Respondent states, "The shareholder does not file the Schedule K-1 with his or her own return, but uses the information contained in it to determine his or her income and tax." Citing *LeBouef v. Comm'r*, T.C. Memo. 2001-261, respondent argues that "an amended Schedule K-1 is not sufficient to prove entitlement to a refund." Respondent asserts that Internal Revenue Code

(IRC) section 1366 provides an S corporation and its shareholders are separate entities and the shareholders account for their *pro rata* share of the S corporation's items of income, deduction, and credit. Citing R&TC section 18601, respondent states, "The S corporation files a California return that is a tax return for the corporation, but the return also reports the share of the items of income, deduction, and credit that each shareholder must take into account in determining his or her own income tax." Respondent asserts, although the auditor denied appellants' claim for refund on the ground they reported an R&D credit in a manner that is inconsistent with how that S corporation item was reported by Atlas, it "does not rely on R&TC section 18601(e) in this appeal from a denial of Appellant's refund claim." (Resp. Opening Br., pp. 5-6; Resp. Reply Br., pp. 6-11.)

R&D Credit

Respondent argues appellants have failed to provide any evidence substantiating Atlas was entitled to claim an R&D credit for 2007 that would have passed through to appellants as shareholders of Atlas. Respondent states appellants have the burden of proving they are entitled to the claimed refund, "regardless of the fact that on appeal Respondent is not relying on the same theory the auditor relied on for disallowing the claim." Respondent points out the auditor denied appellants' claim for refund pursuant to IRC section 6037(c), which is materially the same as R&TC section 18601, subdivision (e), because appellants reported an item on their 2007 amended return in a manner that is inconsistent with how that item was reported by Atlas on its 2007 return. (Resp. Opening Br., pp. 6-8; Resp. Reply Br., pp. 6-11.)

Respondent discusses the requirements for claiming an R&D credit under R&TC section 17052.12 and IRC section 41, including a record keeping requirement. Respondent states, "Appellants must provide a computation of Atlas'[s] research credit such as by using the Form FTB 3523" and they must "provide records with their appeal that would substantiate that Atlas met each and every element required for the research credit as set forth above to support that Atlas had a credit in the amount of $47,829 that passed-through to them as Atlas'[s] shareholders." Respondent asserts, "Appellants should tie such records to each requirement of the research credit." Respondent contends that appellants are not entitled to any refund because they failed to submit an R&D credit computation or "any records substantiating they met the requirements for a research credit in the

amount claimed[.]" In its reply brief, respondent states, "Since Appellants have not provided a computation of the pass-through research credit, it is not clear whether they attempted to make elections in computing the amount of the credit permissible under other provisions relating to or affecting the amount of the research credit that only the S corporation could make." (Resp. Opening Br., pp. 6-8; Resp. Reply Br., pp. 6-11.)

Applicable Law

Subchapter S Items

An S corporation is subject to taxation at reduced rates at the corporate level, but an S corporation's items of income, loss, deduction, and credit are passed through to, and taken into account by, its shareholders in computing their individual tax liabilities. The amount of income, loss, deduction, and credit computed for the S corporation for each tax year are apportioned *pro rata* among the shareholders of the S corporation during its tax year. (Int.Rev. Code, §§ 1366, 1377; Treas. Regs., § 1.41-7(a)(1)(i).)[6]

In determining the tax liability of a shareholder of the S corporation for the shareholder's tax year in which the tax year of the S corporation ends, there shall be taken into account the shareholder's *pro rata* share of the S corporation's items of income, loss, deduction, or credit the separate treatment of which could affect the shareholder's tax liability and nonseparately computed income or loss. (Int.Rev. Code, § 1366(a)(1).) It is necessary for any item of income, deduction, loss, or credit that could affect the shareholder's tax liability to be separately stated because each item's character and amount passes through to the shareholders and most ceilings and limits on certain deductions apply at the shareholder level. (See Treas. Regs., § 1.1366-1.) With the exception for the contribution of noncapital gain property and capital loss property, the character of items of income, loss, deduction, or credit constituting *pro rata* shares is determined for the S corporation and retains that character in the hands of the shareholder. (Treas. Regs., § 1.1366-1(b).)

///

///

[6] Under R&TC section 23800, the provisions of the Internal Revenue Code relating to S corporations are generally applicable in California, except as otherwise provided.

Generally, a shareholder of an S corporation is required to report Subchapter S items,[7] such as an R&D credit, on the shareholder's return in a manner that is consistent with the way in which such items were reported on the corporate return. (Int.Rev. Code, § 6037(c)(1); Rev. & Tax. Code, § 18601, subd. (e)(1).) A shareholder must file a statement with its return which reports an inconsistent treatment of an Subchapter S item when (1) the corporation has filed a return, but the shareholder's treatment of the item on its return is (or may be) inconsistent with the treatment of the item on the corporation's return, or (2) the corporation has not filed a return. (Int.Rev. Code, § 6037(c)(2); Rev. & Tax. Code, § 18601, subd. (e)(2).) In the event the shareholder fails to notify the FTB of the inconsistency, any adjustment required to make the treatment of the Subchapter S item consistent with the way in which the item was reported on the corporate return shall be considered as arising out of a mathematical error and shall be assessed and collected under R&TC section 19051.[8] (Rev. & Tax. Code, § 18601, subd. (e)(3). See also Int.Rev. Code, § 6037(c)(3).)

In *LeBouef v. Comm'r*, *supra*, the Tax Court held that the Schedule K-1 upon which the taxpayers relied "cannot be regarded as more than assertion" of the claimed partnership losses. The Tax Court stated "it has long been held that statements made in tax returns do not constitute proof of the transactions underlying the reported figures." (*Id.* (citations omitted).)

In *Bufferd v. Comm'r*, *supra*, 506 U.S. 523, 533, the United States Supreme Court held that, for assessing the income tax liability of an S corporation's shareholder, the three-year assessment period under IRC section 6501(a), which allows the IRS to assess a tax deficiency within three years from the date the taxpayer filed a federal income tax return, runs from the date the shareholder filed his or her return, not from the date the S corporation's return was filed.

R&D Credit

As discussed more fully below, an appellant has the burden of presenting evidence

---

[7] A Subchapter S item for purposes of R&TC section 18601 is defined as "any item of an 'S corporation' to the extent provided by regulations that, for purpose of Part 10 (commencing with Section 17001) or this part, the item is more appropriately determined at the corporate level than at the shareholder level." (Rev. & Tax. Code, § 18601, subd. (e)(4). See also Int.Rev. Code, § 6037(c)(4).)

[8] R&TC section 19051 provides that a taxpayer has no right of protest or appeal based on a notice mailed to the taxpayer stating that, as a result of a mathematical error, an amount of tax in excess of the amount reported on the return is due. (See also Int.Rev. Code, § 6213(b)(1).)

sufficient to demonstrate that an entity conducted activities that constitute qualified research as defined in IRC section 41. If the entity's claimed activities constitute qualified research, an appellant then has the burden of establishing the amounts claimed as qualified research expenses and substantiating the entity's fixed-base percentage as required by IRC section 41(c)(3)(A).

Burden of Proof

The R&D credit is a matter of legislative grace and the taxpayer bears the burden of proving an entitlement to any credit claimed. (*Indopco, Inc. v. Comm'r* (1992) 503 U.S. 79, 84; *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440.) Statutes granting tax credits are to be construed strictly against the taxpayer with any doubts resolved in the FTB's favor. (*Dicon Fiberoptics, Inc. v. Franchise Tax Board* (2012) 53 Cal.4th 1227, 1236. See also *New Colonial Ice Co., supra*, 292 U.S. at p. 440; *Tax & Accounting Software Corp. v. U.S.* (10th Cir. 2002) 301 F.3d 1254, 1261.)

Moreover, a presumption of correctness attends respondent's determinations as to issues of fact and an appellant has the burden of proving such determinations erroneous. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Jun. 29, 1980.) This presumption is a rebuttable one and will support a finding only in the absence of sufficient evidence to the contrary. (*Id.*) Respondent's determination cannot, however, be successfully rebutted when the taxpayer fails to present uncontradicted, credible, competent and relevant evidence to the contrary. (*Id.*) When the taxpayer fails to support his assertions with such evidence, respondent's determinations must be upheld. (*Id.*) It is also well-established that a taxpayer's failure to introduce evidence that is within his control gives rise to the presumption that the evidence, if provided, would be unfavorable to his position. (*Appeal of Don A. Cookston*, 83-SBE-048, Jan. 3, 1983.)

Qualified Research

R&TC section 23609 provides a tax credit for qualified research expenses determined in accordance with IRC section 41. Insofar as is relevant to this appeal, R&TC section 23609 substantially conforms to IRC section 41. The research credit generally is determined based on the amount by which the taxpayer's qualified research expenses exceed a base amount. To establish that it qualifies for a research credit, a taxpayer must prove that it conducted qualified research during the tax

year at issue. (Int.Rev. Code, § 41(a).)

IRC section 41(b)(1) defines the term "qualified research expenses" as the sum of in-house research expenses and contract research expenses that are paid or incurred by the taxpayer during the tax year in carrying on any trade or business. IRC section 41(b)(2)(A) defines the term "in-house research expenses" to mean any wages paid or incurred to an employee for qualified services performed by him or her, any amount paid or incurred for supplies used in the conduct of qualified research, and, under pertinent Treasury Regulations, any amount paid or incurred to another person for the right to use computers in the conduct of qualified research.

To be qualified research, the claimed research must meet the following four requirements or tests set forth in IRC section 41(d)(1):

(1) the research expenditures must qualify as expenses under IRC section 174 (the section 174 test);

(2) the research activity must be undertaken for the purpose of discovering information that is technological in nature (the technological information test);

(3) the research activity must be undertaken for the purpose of discovering information the application of which is intended to be useful in the development of a new or improved business component of the taxpayer (the business component test); and

(4) substantially all of the research activities must constitute elements of a process of experimentation for a qualified purpose (the process of experimentation test).

(See, e.g., *U.S. v. McFerrin* (5th Cir. 2009) 570 F.3d 672, 676 (*McFerrin*).)

R&TC section 23609, subdivision (c)(2), provides that, "'[q]ualified research' and 'basic research' shall include only research conducted in California."

Section 174

IRC section 174(a)(1) provides that a taxpayer may deduct as expenses any research or experimental expenditures it pays or incurs during the tax year in connection with its trade or business as long as these expenses are not chargeable to the taxpayer's capital account.[9] Treasury Regulation section 1.174-2(a)(1) defines research or experimental expenditures, as used in IRC section 174, as

[9] Alternatively, IRC section 174 allows the taxpayer to defer and amortize the research or experimental expenditures. (Treas. Regs., §§ 1.174-1; 1.174-4.)

"expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense."

IRC section 174(c) generally provides a taxpayer is not allowed to deduct research or experimental expenditures if the acquisition or improvement of the relevant property is of a character that is subject to a depreciation deduction under IRC section 167, "irrespective of the fact that the property or improvements may be used by the taxpayer in connection with research or experimentation." (See also Treas. Regs., § 1.174-2(b)(1).) "[D]eductions under [IRC] section 174 are limited to 'expenditures of an investigative nature expended in developing the concept of a model or product', as opposed to the construction or manufacture of the product itself." (*Union Carbide*, *supra*, 2009 Tax Ct. Memo. LEXIS 50, 216-217.) Accordingly, where "a project involves both the development of the concept of a new or improved process and the use of the process in production, only the activities related to the development of the concept of the process satisfy the [IRC] section 174 test." (*Id*. See also *TG Missouri Corporation v. Comm'r* (2009) 133 T.C. 278.)

Technological Information

The technological information test requires the taxpayer to conduct research "for the purpose of discovering information that is 'technological in nature.'" (*Union Carbide*, *supra*, 2009 Tax Ct. Memo. LEXIS 50, 218.) Information that is technological in nature "fundamentally relies on principles of the physical or biological sciences, engineering, or computer science." (*Id*.) Treasury Regulation section 1.41-4(a)(3) explains:

> (i) . . . Research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.
>
> (ii) . . . A determination that research is undertaken for the purpose of discovering information that is technological in nature does not require the taxpayer be seeking to obtain information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research. In addition, a determination that research is undertaken for the purpose of discovering information that is technological in nature does not require that the taxpayer succeed in developing a new or improved business component.

///

Business Component

The qualified research requirements must be applied separately to each of the taxpayer's business components. (Int.Rev. Code, § 41(d)(2)(A); Treas. Regs., § 1.41-4(b)(1).) IRC section 41(d)(2)(B) defines "business component" as any product, process, computer software, technique, formula, or invention which is to be held for sale, lease, or license, or to be used by the taxpayer in its trade or business. If a taxpayer is not able to satisfy the qualified research requirements with respect to the overall business component, a "shrinking-back" rule is applied. Treasury Regulation section 1.41-4(b)(2) states:

> The requirements [for qualified research] are to be applied first at the level of the discrete business component, that is, the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license, or used by the taxpayer in a trade or business of the taxpayer. If these requirements are not met at that level, then they apply at the most significant subset of elements of the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license. This shrinking back of the product is to continue until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the product is reached and such element fails to satisfy the test. This shrinking-back rule is applied only if a taxpayer does not satisfy the requirements of section 41(d)(1) and paragraph (a)(2) of this section with respect to the overall business component. The shrinking-back rule is not itself applied as a reason to exclude research activities from credit eligibility.

In addition, research activities relating to the development of a product must be analyzed separately from research activities relating to the development of a manufacturing or other commercial production process for that product. (Treas. Regs., § 1.41-4(b)(1).)

Process of Experimentation

The process of experimentation is "a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities." (Treas. Regs., § 1.41-4(a)(5)(i).) In addition, "Uncertainty concerning the development or improvement of the business component (e.g., its appropriate design) does not establish that all activities undertaken to achieve the new or improved business component constitute a process of experimentation." (*Id.*) In other words, "[a] process of experimentation is undertaken for a qualified purpose if it relates to a new or improved function, performance, reliability or quality of the business

component." (Treas. Regs., § 1.41-4(a)(5)(ii).) In *McFerrin, supra*, 570 F.3d at p. 677, the Fifth Circuit Court of Appeals described the process of experimentation as involving the following three steps:

(1) the identification of uncertainty concerning the development or improvement of a business component;

(2) the identification of one or more alternatives intended to eliminate that uncertainty; and

(3) the identification and the conduct of a process of evaluating the alternatives (through, for example, modeling, simulation, or a systematic trial and error methodology).

The "substantially all" factor of the process of experimentation test set forth in IRC section 41(d)(1)(C) "is satisfied only if 80 percent or more of a taxpayer's research activities, measured on a cost or other consistently applied reasonable basis . . . constitute elements of a process of experimentation for a [qualified] purpose[.]" (Treas. Regs., § 1.41-4(a)(6). See also *Union Carbide, supra*, 2009 Tax Ct. Memo. LEXIS 50, 219-220; *Trinity Industries, Inc. v. U. S.* (*Trinity Industries*) (N.D. Texas 2010) 691 F.Supp.2d 688, 692-693, affd. in part, remanded in part, 2014 U.S. App. LEXIS 12568 (5th Cir. Tex. July 2, 2014.) If a business component fails the "substantially all" factor of the process of experimentation test, the taxpayer may utilize the shrinking-back rule, discussed above, until it obtains an element that satisfies the test. (*Union Carbide*, *supra*.)

For purposes of the process of experimentation element, the Tax Court in *Union Carbide, supra*, 2009 Tax Ct. Memo. LEXIS 50, 223-225, explained that a hypothesis must be developed and tested in a scientific manner, the results of those tests must be analyzed, and the hypothesis must either be refined or discarded and a new one developed and the foregoing steps repeated. Furthermore, the Tax Court held that, although only one alternative needs to be identified under Treasury Regulation section 1.41-4(a)(5)(i), the process of experimentation generally should be capable of analyzing more than one alternative. (*Id.*) The Tax Court further stated, "If only one alternative is tested, for that alternative to constitute a process of experimentation the taxpayer should conduct a series of experiments with the alternative in order to develop the business component." (*Id.*)

Qualified Research Expenses

Qualified research expenses "are limited to salaries and wages, supplies and contract

research performed by third parties." (*Bayer Corp. v. United States* (W.D. Pa. 2012) 850 F.Supp.2d 522, 524 (*Bayer*).) Qualified research expenses consist of the sum of in-house research expenses and contract research expenses that the taxpayer paid or incurred during the tax year in carrying on its trade or business. (Int.Rev. Code, § 41(b)(1).) The term "in-house research expenses" consists of "any wages paid or incurred to an employee for qualified services performed by such employee," as well as "any amount paid or incurred for supplies used in the conduct of qualified research." (Int.Rev. Code, § 41(b)(2)(A).)

The term "qualified services" means services consisting of the following: "(i) engaging in qualifying research, or (ii) engaging in the direct supervision or direct support of research activities which constitute qualified research." (Int.Rev. Code, § 41(b)(2)(B).) "The term 'engaged in qualified research' as used in [IRC] section 41(b)(2)(B) means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments)." (Treas. Regs., § 1.41-2(c)(1).) "The term 'direct supervision' as used in [IRC] section 41(b)(2)(B) means the immediate supervision (first-line management) of qualified research (as in the case of a researcher who directly supervises laboratory experiments, but who may not actually perform experiments)." (Treas. Regs., § 1.41-2(c)(2).) "Direct supervision" does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist." ((*Id*.) See also *Shami v. Commissioner* (5th Cir. 2014) 741 F.3d 560, 570.)

A taxpayer must establish a nexus between the claimed wages and the qualified services. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes qualified research expenses. (Treas. Regs., § 1.41-2(d)(1).) If during the tax year 80 percent of an employee's wages consist of qualified services, then all of the employee's wages are allocated to the performance of qualified services and constitute qualified research expenses. (Treas. Regs., § 1.41-2(d)(2). See also *Shami v. Comm'r, supra*, 741 F.3d at p. 570.) In the absence of an alternative method that the taxpayer demonstrates is more appropriate, the amount of an employee's wages allocated to qualified services shall be determined by multiplying the total amount of wages paid to the employee during the tax year by the ratio of the total time the employee actually spent in the performance of qualified services to the

total time the employee spent in the performance of all services during the tax year. (Treas. Regs., § 1.41-2(d)(1).)

Recordkeeping

Taxpayers are required to maintain sufficient records to substantiate all credits claimed on their tax returns. (Int.Rev. Code, § 6001; Treas. Regs., § 1.6001-1(a).) (See also *Sparkman v. Comm'r* (9th Cir. 2007) 509 F.3d 1149, 1159.) A taxpayer claiming a research credit is required to "retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." (*Shami v. Comm'r*, T.C. Memo. 2012-78, affirmed in part and vacated in part, 741 F.3d. 560.) Treasury Regulation section 1.41-4(d) sets forth the following recordkeeping requirement for research credit claims:

> Recordkeeping for the research credit. A taxpayer claiming a credit under [IRC] section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. For the rules governing record retention, see [Treasury Regulations] Sec. 1.6001-1. To facilitate compliance and administration, the IRS and taxpayers may agree to guidelines for the keeping of specific records for purposes of substantiating research credits.

IRC section 6001 states the general recordkeeping requirement for taxpayers:

> Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title.

Treasury Regulations section 1.6001-1(a), which is referenced in Treasury Regulation section 1.41-4(d), also provides general recordkeeping requirements for taxpayers:

> . . . [A]ny person subject to tax under subtitle A of the Code . . . or any person required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.

Other than Treasury Regulations section 1.41-4(d), and its cross-reference to these general recordkeeping requirements, there is no specific recordkeeping requirement under IRC

section 41. If a taxpayer establishes that it paid or incurred an expense without establishing the amount of the expense, a court and the Board "may approximate the amount of the expense, bearing heavily against the taxpayer whose inexactitude is of [its] own making." (*Shami*, *supra*, T.C. Memo. 2012-78 (citing *Cohan v. Comm'r* (2d Cir. 1930) 39 F.2d 540, 543-544).) This is known as the *Cohan* rule. "For the *Cohan* rule to apply, however, a reasonable basis must exist on which [a] Court can make an estimate." (*Id.* (citations omitted).) "Without such a basis, any allowance would amount to unguided largesse." (*Id*. (citations omitted).) In other words, a taxpayer must demonstrate some "rational basis on which an estimate can be made" that goes beyond mere speculation, unsupported allegations, or mere inference. (*Vanicek v. Comm'r* (1985) 85 T.C. 731, 742-43. See also *Fudim v. Comm'r*, T.C. Memo. 1994-235; *Eustace v. Comm'r* (7th Cir. 2002) 312 F.3d 905; *Union Carbide*, *supra*; *Trinity Industries v. United States*, *supra*, 691 F.Supp. 2d 688; *Bayer*, *supra*, 850 F.Supp.2d 522, 539; *McFerrin*, *supra*, 570 F.3d at p. 679.)

In *Shami*, *supra*, T.C. Memo. 2012-78, the taxpayers claimed that certain wages the company paid to two of its executives, Mr. Shami and Mr. McCall, were qualified expenses for the research credit. The Tax Court found that the company's research and development was performed across numerous departments and by many employees. The Tax Court held, "while petitioners are not required to show that Mr. Shami and Mr. McCall wore lab coats, petitioners must substantiate the time Mr. Shami and Mr. McCall spent performing qualified services and the total time they spent performing all other services." The Tax Court concluded that the testimony of the two executives and two employees offered by the petitioners to substantiate the time the executives purportedly spent performing purported qualified services was "self-serving and unreliable." The Tax Court found that several witnesses contradicted one of the executive's testimony and no witnesses corroborated the other executive's testimony. In addition, the Tax Court found the testimony of two employees of the company "was general, vague, conclusory and insufficient to establish the time" either executive "spent performing any specific service." The Tax Court thus held "that the inadequate substantiation prevents any amount of the relevant wages from qualifying for the research credit." In addition, the Tax Court held that the *Cohan* rule does not apply because there was insufficient evidence to estimate the appropriate allocation of wages between qualified services and nonqualified services. The Tax Court

stated in *McFerrin*, *supra*, 570 F.3d 672, the appellate court "did not overrule, or even address, the basic requirement under *Cohan* that a court must have a reasonable basis upon which to make an estimate," and the *McFerrin* decision does not require it "to estimate the amounts of Mr. Shami's or Mr. McCall's wages that are allocable to qualified services given [its] finding that [it] lack[s] a reasonable basis upon which to make such an estimate."

On appeal, the Fifth Circuit Court of Appeal affirmed the Tax Court's holding in *Shami*, except for its failure to include supply costs as proper qualifying research expenses when calculating each of the taxpayers' deficiencies because the IRS previously conceded that it would not challenge the claimed QREs except for those related to highly paid employees. The Fifth Circuit Court of Appeal stated, "The Tax Court's failure to include the supply costs as proper QREs when calculating each Petitioner's deficiency therefore was clearly erroneous." The Fifth Circuit Court of Appeal thus vacated "the Tax Court's judgment as to each Petitioner and remand for recalculation of the deficiencies in light of the Commissioner's concession." (*Shami v. Comm'r*, *supra*, 741 F.3d 560.)

Fixed-Base Percentage

Generally, the research credit is determined based on the amount by which the taxpayer's qualified research expenses exceed a "base amount." For tax years beginning on and after January 1, 2000, the California research credit, pursuant to R&TC section 23609 (which conforms to IRC section 41 with specified exceptions), shall be an amount equal to 15 percent of the excess (if any) of the taxpayer's qualified research expenses for the tax year over the base amount. (Rev. & Tax. Code, § 23609, subd. (b)(3)(A); Int.Rev. Code, § 41(a)(1).) For purposes of the California research credit, "qualified research" only includes research conducted in California. (Rev. & Tax. Code, § 23609, subd. (c)(2)(A).)

If a taxpayer incurred qualified research expenses during at least three of the years from 1984 through 1988, then its fixed-base percentage is equal to its total qualified research expenses as a percent of its total gross receipts for that period, but not to exceed 16 percent." (Int.Rev. Code, § 41(c)(3)(C).) The base amount is computed by multiplying the taxpayer's fixed-base percentage by its average gross receipts for the four years immediately prior to the current year. (Int.Rev. Code, § 41(c)(1).) The base amount cannot be less than 50 percent of the current year's qualified expenses.

(Int.Rev. Code, § 41(c)(2).) (See also California Legislative Analyst's Office, "An Overview of California's Research and Development Tax Credit" (Nov. 2003), p. 6.)

If a taxpayer would prefer not to use data from the 1984 to 1988 period to calculate its credit, the taxpayer may elect to apply an alternative credit, which calculates the base amount and consequently the amount of the credit without using data from the 1984 to 1988 period. However, an election to apply the alternative incremental research credit shall only be made on the taxpayer's original return; it may not be made on an amended return. (Int.Rev. Code, § 41(c); Treas. Regs., § 1.41-8(2).)

Alternatively, IRC section 41(c)(3)(B) provides a different fixed-base percentage for start-up companies for purposes of computing the research credit. IRC section 41(c)(3)(B) defines a taxpayer as a start-up company for this purpose if "the first taxable year in which [the] taxpayer had both gross receipts and qualified research expenses begins after December 31, 1983," or "there are fewer than 3 taxable years beginning after December 31, 1983, and before January 1, 1989, in which the taxpayer had both gross receipts and qualified research expenses." For such taxpayers, the fixed-base percentage is "3 percent for each of the taxpayer's 1st 5 taxable years beginning after December 31, 1993, for which the taxpayer has qualified research expenses." (Int.Rev. Code, § 41(c)(3)(B)(ii)(I).)

STAFF COMMENTS

To date, appellants have provided no evidence to support their assertion that Atlas conducted qualified research and otherwise satisfied the requirements necessary to substantiate the claimed R&D credit for the tax year at issue.[10] At least 14 days prior to the oral hearing, appellants should provide all available evidence supporting their claim that Atlas engaged in qualified research and otherwise met the requirements for the R&D credit.[11] To facilitate review, any evidence submitted

[10] Staff notes that, prior to appeal, in a February 6, 2013 letter to appellants, respondent stated that "We are unable to allow your claim for refund without documentation substantiating your claim." As noted above, respondent also noted the lack of substantiating evidence in its briefing on appeal.

[11] If appellants provide a credit study or calculation schedules, they should also include the source documentation used in preparing the study and schedules. In addition to demonstrating whether qualified research occurred, the amount of qualifying expenses incurred, and the calculation of the credit amount, appellants will want to demonstrate that Atlas conducted the qualified research activities in California. (See Rev. & Tax Code, § 23609, subd. (c)(2).)

should be provided in an organized fashion that ties the evidence provided to the applicable legal requirements and appellants' calculation of the amount of the claimed credit.

At the hearing, appellants should be prepared to explain how they, on the basis of appellant-husband's interest in Atlas, could be entitled to claim a *pro rata* share of an R&D credit for Atlas in light of the the fact Atlas never claimed any R&D credit for the year at issue and the consistency requirements of R&TC section 18601, subdivision (e). It is undisputed that Atlas filed its 2007 original return on April 24, 2008, which did not claim any R&D credit. Appellants later filed a 2007 amended return in which they claimed a *pro rata* share of Atlas's R&D credit on the basis of an amended Schedule K-1 appellants asserted they received from Atlas. However, Atlas never filed a 2007 amended return or claimed any R&D credit on its 2007 original return. In light of these facts and the requirements of R&TC section 18601, subdivision (e), the Appeals Division questions whether appellants could be entitled to claim an R&D credit for the year at issue.

///

///

///

Shekhter_lf